

# NAVAL POSTGRADUATE SCHOOL

## Monterey, California



## THESIS

THE EVALUATION OF APPROPRIATENESS OF OMB  
CIRCULAR A-76 STUDIES ON REVENUE-GENERATING  
FUNCTIONS IN DEFENSE WORKING CAPITAL FUND  
ACTIVITIES

by

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December 2002

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STUDIES ON REVENUE GENERATING FUNCTIONS IN DEFENSE WORKING  
CAPITAL FUND ACTIVITIES**

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## **ABSTRACT**

This thesis addresses the appropriateness of applying an OMB Circular A-76 study process on the revenue generating functions in Defense Working Capital Fund activities. While the thesis acknowledges that subjecting organizational functions to an A-76 process gains competitive efficiencies, the hypothesis is that a Working Capital Fund activity has already realized the efficiencies by competing for business; therefore, a process other than A-76 is more appropriate to gain further cost savings. The thesis examines the specific example of the Navy Supply Information Systems Activity (NAVSISA), which is a Fee-for-Service organization that specializes in providing informational technology products and services for U.S. Navy, DoD and Foreign Allies.

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## **I. INTRODUCTION**

### **A. BACKGROUND**

In the mid 1950's, under the Eisenhower Administration, the Executive Branch of the U.S. Government, initiated the shift of Department of Defense commercially available goods and services towards the procurement from the private sector. [Ref. 16] This Commercial-Industrial Studies Program developed procedures and guidelines for outsourcing that would result in cost savings while still obtaining the correct support. The policy stated, "Federal agencies will not provide a function in-house that is obtainable from a private source unless Government performance of that function has been justified in the national interest." [Ref. 5] This executive directive is the foundation of the OMB Circular A-76 process, however little change actually occurred from how the Department of Defense conducted business.

Due to criticism and political changes, the Office of Management and Budget (OMB) revised the original A-76 process. The first revision (1967) provided formal guidelines for cost comparison procedures. A 1979 revision defined whether an agency had a requirement to contract out non-inherently governmental functions. In 1983, after a two-year analysis of the A-76 Circular process, the OMB updated the Circular No A-76 and set procedures in place to reestablish the initial objective of the Eisenhower administration. The new procedures established when private companies could perform commercial activities previously performed by the government. OMB was leading

the government away from performing activities that commercial sources could produce more economically, unless the functions received the designation of "inherently governmental."

The OMB Circular A-76 study is the directive requiring executive agencies to determine whether their activities are inherently governmental or have a commercial nature. The policy encourages competition and choice in the management and performance of commercial activities, outsourcing those functions where economical to do so. This frees the government agency to focus on inherently governmental core activities.

#### **B. PURPOSE**

This thesis addresses the appropriateness of applying an OMB Circular A-76 study process on the revenue generating functions in Defense Working Capital Fund activities. While the thesis acknowledges that subjecting organizational functions to an A-76 process gains competitive efficiencies, the hypothesis is that a Working Capital Fund activity has already realized the efficiencies by competing for business; therefore, a process other than A-76 is more appropriate to gain further cost savings. The thesis examines the specific example of the Navy Supply Information Systems Activity (NAVSISA), which is a Fee-for-Service organization that specializes in providing informational technology products and services for U.S. Navy, DoD and Foreign Allies.

#### **C. RESEARCH OBJECTIVE AND QUESTIONS**

The primary objective of this research is to determine if the OMB Circular A-76 process is appropriate for cost

reductions and increasing efficiency in a Defense Working Capital Fund organization. The subsidiary questions are:

- What is the basis and objectives of the A-76 study?
- How does a Working Capital Fund (WCF) activity operate competitively and financially?
- What other means of cost-cutting are in place at the Defense Working Capital Fund activities?
- Have A-76 studies shown effectiveness at Defense Working Capital Fund activities?
- Are there parallels between the current DWCF business strategy and the objectives of the A-76 study?
- What challenges are there when doing an A-76 at a Working Capital Fund activity?

#### **D. SCOPE AND LIMITATIONS**

The scope of this thesis provides an objective assessment to DoD as to whether an OMB A-76 study is the appropriate process for gaining efficiencies in revenue-generating functions in Defense Working Capital Fund organizations. The scope of the study includes:

- A review of the rationale of A-76 studies with respect to competition and efficiency
- The nature of competition in awarding business to WCF organizations
- The competitive parallels of A-76 studies and WCFS organizations
- The evaluation of NAVSISA, a specific WCF organization undergoing an A-76 study

The scope will not include:

- An in-depth history on the evolution of the A-76
- An in-depth analysis of the costs of performing an A-76 study
- An in-depth history of NAVSISA

- An in-depth analysis of the Fee-for-Service organizations or Defense Working Capital Fund
- An in-depth analysis of the contracting process in the DoD system

The thesis concludes with recommendations to improve the use of A-76 studies at WCF organizations.

#### **E. RESEARCH METHODOLOGY**

The methodology used in this research consists of the following steps:

- Conduct a literature search of books, magazine articles, journals, World Wide Web, Department of Defense (DOD) references, and other library information resources with respect to A-76 studies and FFS organizations
- Review the legislative & policy intent of the uses of the A-76 study
- Conduct interviews and group discussions with personnel from NAVSISA
- Review the accounting procedures of the Working Capital Fund and Fee-for-Service organizations
- Conduct interviews with personnel from OMB and Navy Strategic Sourcing Officer involved with A-76 studies
- Conduct interviews with Comptrollers in other WCF organizations
- Construct a presentation of the current challenges of using an A-76 at WCF organizations
- Show the inappropriateness of the A-76 study at a WCF organization
- Suggest alternative processes for cost-cutting at WCF organizations

#### **F. ORGANIZATION OF STUDY**

Chapter I. Introduction: This chapter identifies the purpose of the thesis, primary research questions, the methodology and benefits of the study.

Chapter II. Current use of A-76 studies in the DoD:

This chapter introduces the OMB Circular A-76, provides a brief history of the study and summarizes the process as used today. The research examines the use of the A-76 process in the Department of Defense noting the absence of organizational distinction.

Chapter III. Understanding the Defense Working Capital Fund: This chapter provides background and history on the Defense Working Capital Fund and evaluates the business principles and components of the revolving fund. The research presents the Working Capital Fund business strategy with a comparison to the private sector and addresses uniqueness of some DoD Working Capital Fund activities.

Chapter IV. A-76 study at a Working Capital Fund Activity: This chapter focuses on how the Working Capital Fund applies free market economics and how the foundational theories of the Defense Working Capital Fund and the A-76 study parallel each other. The research addresses the challenges of doing an A-76 study at the Working Capital Fund and a case study presented of NAVSISA, a NAVSUP information systems Working Capital Fund undergoing an A-76 study.

Chapter V. Conclusion and Recommendations: This chapter provides conclusions, recommendations, answers to the research questions and includes suggested areas for further research.

**G. BENEFITS OF THE STUDY**

This study will show that using the OMB Circular A-76 study on the revenue generating functions in a Defense

Working Capital Fund activity is not an appropriate method of cost-cutting and efficiency evaluation, and that competition may exist in some DWCF that are already reaping organizational cost savings and efficiency. The study will show why the A-76 is not the appropriate tool, using a Navy Working Capital Fund organization as an example and include recommendations of alternative means of gaining cost efficiencies at Working Capital Fund Commands.

## **II. CURRENT USE OF A-76 IN THE DOD**

This chapter will introduce the OMB Circular A-76 process. A brief history precedes a summary of the process as used today. Next, the chapter examines the use of the A-76 process in the Department of Defense noting the absence of organizational distinction. This chapter will provide the foundation for the analysis to follow in subsequent chapters.

### **A. HISTORY OF THE A-76**

The origin of the A-76 process dates back to the Eisenhower Administration in 1955 with Budget Bulletin 55-4. The Budget Bulletin stated, "It is the general policy of the Federal Government that it will not start or carry on any commercial activity to provide a service or product for its own use if such product or service can be procured from private enterprise through ordinary business channels." [Ref. 8] The key assumption of the A-76 is that the market place can provide some products and services more economically and efficiently than if, the Department of Defense produces them internally. The A-76 was one of several Defense reform initiatives that DoD implemented to generate savings through modernization and cost-cutting methods. With the fall of the Soviet Union in the early 1990's and the shrinking Defense budget, the A-76 initiative became a critical tool aimed at maximizing the efficient use of scarce Government resources.

A key point, however, is that the A-76 process is indiscriminant to the type of Command it is evaluating. Whether a Mission-Funded Command, a reimbursable Command,

or a Working Capital Fund activity, the A-76 is blind to Command funding mechanisms. Nowhere in the OMB Circular A-76 guidance is anything specified as to the determination of how funding is received by the Command. This fact is not pertinent to the A-76 processes. The objective of the A-76 is to initiate a more competitive environment to achieve economy and enhanced productivity. The A-76 evaluation is for all DoD functions and organizations, without exemption, except for those organizations specifically listed in the OMB Circular directive. [Ref. 27]

#### **B. PRIMARY OBJECTIVES OF THE A-76**

The primary function of the OMB Circular A-76 study is to set forth the procedures for determining the performance of commercial activities by commercial sources or in-house Government facilities and personnel. [Ref. 27] The principle behind the A-76 is to have the Government rely on the private sector to purchase goods and services that are not part of their core competencies in order to decrease costs and improve quality. In 1983, OMB issued a major update to the A-76 Circular to clarify procedures and streamline the evaluation process for outsourcing determinations. Three fundamental principles define the goals of the A-76 process:

- Achieve economy and enhance productivity
- Keep inherently governmental functions "in-house"
- Rely on commercial sector for products and services if determined economical

Given a finite amount of funding for operations, readiness and installations operation, DoD has had to gain the most out of each dollar appropriated. Due to fiscal



restraints within the past few years on the DoD budget, the emphasis on outsourcing and competitive sourcing has increased greatly. [Ref. 19] The A-76 studies have resulted in substantial savings achieved through the process of using commercial activities.

In 1996, the Circular further clarified procedures for determining whether recurring commercial activities move under contract. The revision added:

- Balance the interests of the parties to make or buy cost comparisons
- Provide a level playing field between public and private offeror to a competition
- Encourage competition and choice in the management and performance of commercial activity [Ref. 27]

The focus of the revision was to initiate the competition for new or expanded work based on an A-76 cost comparison.

OMB also recognized in 1999 that it needed more clarity regarding the move towards the use of the private sector and foundation that the government should not compete with its own citizens and the use of commercial activities. The Circular A-76, 1999 Revision, outlines the following:

- The government may engage in inherently commercial activities if it can be determined that the function is critical to combat effectiveness or that mission effectiveness will suffer because of outsourcing
- A commercial source is not available or cannot provide the product or service that meets the governments requirements or in a timely manner
- Another Federal agency can provide the goods or services. Government agencies are often required

to compete under the oversight of the A-76 guidelines.

- Procuring from commercial firms will result in a higher cost to the government than if the item is produced internally
- Items that were inherently governmental in nature are to be excluded from consideration from outsourcing [Ref. 27]

The government does recognize that there are certain functions that are "inherently governmental" and so intimately related to the public interest as to require only Federal governed control. [Ref. 28] Appendix A includes the clarification of the definitions of inherently governmental functions. These are the only inherently governmental functions currently accepted by the Office of Federal Procurement Policy.

Another important piece of the Circular A-76, 1999 revision, was Federal policy regarding the performance of commercial activities and implementation of the statutory requirements of the Federal Activities Inventory Reform Act (FAIR). This law requires that the head of each executive agency submit to the Director of OMB and Congress a list of activities performed by Federal Government sources for the executive agency, which in their opinion are not inherently governmental. [Ref. 11] This was an important legal move by the Congress, which prepared the executive agencies to evaluate cost efficiencies using the A-76 strategy.

The OMB Circular has matured over time and has evolved into an effective tool to move the delivery of non-inherently governmental products of goods and services to the private sector. Although the A-76 process has taken time to implement, the initiative of cost savings through

competition has been a tool actively used for cost efficiencies and savings.

The A-76 also assumes that there will be competitive markets with many competing suppliers capable of providing and bidding for business. If competitive markets do not exist, OMB should reevaluate the use of the A-76 study to prevent the application of non-value added cost reduction tools. [Ref. 21]

### **C. THE A-76 PROCESS**

The A-76 is a comprehensive 12-step process (Table 2.1) that takes approximately 18 to 36 months, depending on the complexity of the organization. The process determines what functions will be retained by government workforce or contracted to a commercial firm. [Ref. 27] The steps are as follows:

<b>A-76 Twelve Step Process</b>	
Step 1	Packaging and Commercial Activity Identification
Step 2	Public Announcement
Step 3	Formulation of Performance Work Statements & Quality Assurance Surveillance Plan
Step 4	Solicitation
Step 5	Creation of Governmental Management Plan
Step 6	Independent Review
Step 7	Negotiation Phase
Step 8	Selection of a Single Provider
Step 9	Cost Comparison
Step 10	Administrative Appeals
Step 11	Implementation of MEO
Step 12	Post A-76 Actions

Table 2.1. A-76 Process.

## **1. Packaging and Commercial Activity Identification**

Packaging, also called "business unit definition" is the process of deciding which commercial activities will comprise the cost comparison and structures them into organized business units suitable for competition. Effective packaging is the critical first step that maximizes the presence of competition later in the cost comparison process (Step 8). Packaging relates to the annual OMB and DoD Inventory of Commercial Activities, since the packaging process first requires a decision about what functions are compatible and can be included in the cost comparison. [Ref. 40]

Separation of functions is sometimes necessary to provide the greatest amount of competition for bids. The focus of packaging is to attempt to bundle functions that are similar to create a bid in one package, while separating out independent functions. If done incorrectly, the packaging process limits the contractor's ability to compete for contracts due to unrealistic demands in multifunction contracts. Recognizing the implications of asset specialty, complexity and frequency at the beginning of the process will maximize potential bidding practices.

Step 1 uses a designated Command study team in addition to the OMB FAIR Act I identification list. The organization under study evaluates their individual commercial activities and designates those most suitable for competition.

## **2. Public Announcement**

With the study team formed and the designated areas of study identified, a public announcement notifies Congress that a commercial activity is under competition with the A-76 guidelines and the timeline begins. The designated agency also notifies the local community and local federal workforce of the study. The Unit Commander is the central point of contact for all issues concerning the A-76 study and the Commander appoints a designated team leader to oversee the entire study process.

Operations that are more complex will require more detailed work descriptions to illustrate the larger organization. This complexity often leads to the addition of an independent experienced perspective and outside consultants to assist in the study.

## **3. Formulation of Performance Work Statements & Quality Assurance Surveillance Plan**

After the official announcement of the study, acquisition actions begin and the study team places the functions deemed "subject to competition" into Performance Work Statements (PWS) and a Quality Assurance Surveillance Plan (QASP). The PWS outlines the product requirements, including timeframes, and performance measures and standards, which will form the basis of the Request for Proposal. The PWS describes the work performed, including the definition of results from the commercial activities identification. The development of the PWS is the cornerstone of the study and a critical piece that takes time and effort to create. Without the correct attention to the PWS, the entire study can be an unproductive effort

that creates a description that does not meet the true requirements of the organization.

The Quality Assurance Surveillance Plan (QASP) describes the procedures to verify the selected proposal meets the requirements listed in the PWS, no matter who wins the cost comparison. The QASP describes methods of inspection, required reports, resources used and focuses on the quality of the products rather than the procedures used to provide them. The QASP will use metrics and performance measures for the development of cost comparisons. Once effective PWS and QASP are developed, the study team is ready for the solicitation stage.

#### **4. Solicitation**

The solicitation phase includes all of the pre-acquisition steps: determining the appropriate contract type, creating the source selection plan, developing evaluation criteria, developing the independent cost estimate and then preparing and releasing the request for proposal (RFP). The RFP offers the opportunity to private industry to enter bids and proposals. The RFP solicitation must specify that the final award be solely on cost comparisons with in-house providers. The RFP also includes a "First Refusal of Employment" clause that ensures in-house Federal employees, whose positions are under consideration for outsourcing, receive priority for employment if the function goes to a private contractor. If an A-76 study solicitation results in no bids from the private market, the Government automatically retains the function but still must implement the MEO.

#### **5. Creation of Government Management Plan**

The Management Plan describes the Government's Most Efficient Organization (MEO) and is the basis for the Government "In-House Cost Estimate"(IHCE). The IHCE is the government estimate of the cost to perform the functions described in the PWS. The Management Plan should identify the organizational structures, staffing and operating procedures, equipment, and transition and inspection plans necessary to ensure that the government can perform the activity in the most efficient and cost effective manner. The Management Plan includes four documents, the MEO, IHCE, Technical Performance Plan (TPP), and the Transition Plan (TP). [Ref. 40] The following reviews the Government Management Plan:

- The MEO is the document that contains the government estimate for performing the commercial activity in-house as described in the PWS. The MEO outlines the proposed organizational structure, administrative and staffing functions, and operating procedures of the in-house organization. The MEO lays the foundation for the Government Management Plan and is the vital piece of information developed by the study team.
- The IHCE contains the cost estimate for the MEO and provides a description of all costs associated with the performance of the MEO. These costs are overhead, staffing, severance costs, and miscellaneous costs. The IHCE also lists any organic assets not provided to the contractor, which the MEO will use. The IHCE develops solely on the MEO, so if the MEO is incorrect the IHCE is incorrect.
- The TPP details how the government agency will carry out the requirements in the PWS if the A-76 study remains governmental. It is the implementation of the Government Management plan after the study is completed.

- The TP outlines the transition process to the government MEO or to the contractor if the function is outsourced.

The study team must carefully construct these documents to ensure there is consistent management oversight and correct requirements generated to have a successful study. [Ref. 39]

## **6. Independent Review**

During the Independent Review, an Independent Review Officer (IRO) evaluates the PWS, QASP, MEO, IHCE, TPP, and TP to ensure the requirements are adequate and realistic. The IRO should be an agency official who has not been involved in any aspects of developing the Governmental Management Plan. The main responsibility of the IRO is to ensure that the documents establish the Government capability to perform the function described in the PWS with the resources identified in the MEO and that all costs determined by the IHCE are justified.

## **7. Negotiation Phase & Selection of a Single Provider**

This phase begins with Contracting Officer discussions with private sector organizations that have submitted bids. The discussions may be written or oral with the goal of resolving any discrepancies in the cost proposals and must be in accordance with the Federal Acquisition Regulation (FAR). From the proposals and any changes made, the CO selects a single firm based on their ability to meet the requirements of the MEO. The selection is a "best value" choice vice the "cost comparisons" method used later. The expected outcome of the selection using the best value option bases the choice of contractor on the greatest



overall value to the Government in response to the solicitation.

#### **8. Cost Comparison**

At this stage in the process, the Source Selection Authority (SSA) compares the in-house MEO and IHCE with the selected private sector proposal. The SSA, who is usually the Contracting officer, makes a determination that the Government technical proposal will provide the same level of support and performance as the selected bided offer. If the Government in-house proposal is deficient in any way, there is a revision to ensure a fair comparison. The objective of the cost comparison is to ensure that the two proposals provide the same scope of work and level of performance and bases the final selection on lowest cost. This cost comparison creates a tentative decision to accept either the in-house MEO or the contractor external bid.

There is a minimum cost differential requirement. This differential requires the contractor proposal to be 10% lower than the Government proposal or \$10M less over the performance period, whichever is less. If the contractor proposal is above the threshold, the function remains in the government. The minimum cost differential requirement is to account for the cost of conversion to a private contractor when there is only a small savings realized. Upon the passing of the threshold test, the Contracting Officer informs the Unit Commander of the tentative decision to prepare for the official announcement.

#### **9. Administrative Appeals**

The Administrative Appeals process focuses on errors made in the cost comparison steps. Appeals to the A-76

steps must be in writing and received by the contracting officer within the review period. The contractor submitting the appeal has to have submitted a proposal for bid. Federal employees or government agencies eligible for replacement by outsourcing may also submit an appeal. Overall, in the appeals process, the cost comparison is the most frequent point or issue of appeal. [Ref. 27]

#### **10. Implementation of MEO or Contractor Organization**

When the Administrative Appeal process is completed the final selectee, whether the government in-house MEO or contractor, begins the Transition Plan (TP). The TP will address the personnel management issues, transfer of equipment and inventories, and any procedural changes. In the case where the organization implements the MEO, the organization conducts a formal review and inspection following the end of the first full year of performance. The Post-MEO Performance Review confirms that the MEO has been implemented in accordance with the Transition Plan, establishes the MEO ability to perform the services of the PWS and confirms that actual costs are within the estimates contained in the in-house estimate. [Ref. 40]

#### **11. Post A-76 Actions**

Upon completion of the A-76, the new organization begins full performance of its duties and the Government implements the QASP regardless of the final choice. The organization reviews the QASP periodically to ensure the validity of the PWS set by the A-76. In the case where the organization implements the Government MEO, a formal review and inspection of the MEO occurs at the end of the first year of operation. This review and inspection verifies

that the MEO is indeed in accordance with the Government Management plan.

**D. RESULTS AND EFFECTIVENESS OF THE A-76 STUDY**

The data below shows that the A-76 process does save money.

<b>Service</b>	<b># of A-76 Studies Completed</b>	<b>Savings from reduced FTE (FY96)</b>	<b>% Savings (reduction of FTE \$ over total budget)</b>
Army	510	\$470M	27%
Air Force	733	\$560M	36%
Marine Corps	39	\$23M	34%
Navy	806	\$411M	30%
Other DoD	50	\$13M	28%
Total	2138	\$1,478M	30%

Table 2.2. A-76 Savings FY 1978-1996. [Ref. 30]

Table 2.2 provides data that shows each individual service and the total number of studies done through 1996. The savings demonstrated results from the total reduction of Civil Service Full Time Equivalent (FTE) employees. The decisions from the A-76 are either an in-house MEO or commercial contract. There is no documentation of operational savings gained by the A-76 and the table demonstrates only personnel savings. Dividing the total savings by the total budget creates the percentage saved for all the organizations studied. In cases where the application of the OMB A-76 resulted in competition between private and public sector, the results ranged from a 27%-36% cost savings. The average was 30% regardless if the final selection was private contactor or the in-house MEO.

[Ref. 24] The Navy Strategic Sourcing Unit demonstrates data that is more recent for the Department for the Navy:



## Strategic Sourcing Program: A-76

25-Oct-02

### Status

#### *Cost Comparisons:*

135 in progress, 15,074 FTE  
134 completed, 15,022 FTE  
77% Navy MEO selected  
23% Contract offer selected  
27 months to complete

#### *Streamlined:*

5 in progress, 161 FTE  
29 completed, 1,053 FTE  
100% Navy MEO selected

#### *Direct Conversions:*

70 in progress, 494 FTE  
47 completed, 1,396 FTE

### Savings

#### *Completed Cost Comparisons:*

Total Annual Savings \$372M  
Average Savings 43.6%

Cost savings compared to average:

<u>Decision:</u>	<u>Navy MEO</u>	<u>Contract</u>
*Small studies (*less than 250 FTE)	-12%	- 5%
Large studies	-2%	23%

#### Total FTE reductions:

Navy MEO - 46%  
Contract - 100%

#### *Completed Direct Conversions:*

FTE reductions 100%  
Total Annual Savings \$29M

Figure 2.1. Navy Strategic Sourcing A-76 Savings.  
[Ref. 41]

The Navy Strategic Sourcing Program data reflects the status of the hundreds of studies conducted in the DoN from FY96 through FY02, the number of FTE evaluated and the cost savings already recognized Navy wide. Figure 2.1 shows the total annual savings of \$372M and the average savings of 43% per Command studied is significantly higher than the DoD average demonstrated in Table 2.2. The savings demonstrated is all with the reduction of labor and FTE.

## **E. CHAPTER SUMMARY**

This chapter introduces the A-76 process, gives a general understanding of how the process creates savings by introducing competition, and strives for economy and

enhanced productivity. The competitive sourcing process takes advantage of two factors, the ability to efficiently utilize available labor and the use of economies of scale. This emphasizes the value of introducing competition into an organization in order to bring about reduced costs of operation and draw out new efficiencies. If done correctly, competitive sourcing not only saves money, it helps the DoD to be an organization that thrives on competition, innovation, responsiveness to changing need, efficiency, and reliability. [Ref. 22] The introduction of competition has the ability to force stagnant Government organizations into self-evaluation through external influences to become better and more efficient at what they do. The cost comparisons and the competition itself compel both the Government and industry to become more efficient and drive each element to improve. [Ref. 37] Finally, the chapter shows the benefits and cost savings when doing an A-76, as well as the inability of the A-76 to look at distinctions in different organizations. By clearly understanding the background of the A-76 process, the reader can see how there may be challenges when the study addresses the Working Capital Funds Command.

Given this foundation, the next chapter will begin to look at Working Capital Funds and how, in many cases, they face competition generated under the principles of free market fundamentals.

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### **III. UNDERSTANDING THE DEFENSE WORKING CAPITAL FUND**

This chapter provides background and history on the Defense Working Capital Fund and evaluates the business principles and components of the revolving fund. The research also addresses the uniqueness of some DoD activities operating as Working Capital Funds.

This chapter will add further foundation for the analysis to follow in the subsequent chapters.

#### **A. BACKGROUND AND HISTORY**

The 1949 National Security Act originally established the use of a system of business practices called "revolving funds" in the DoD. [Ref. 7] A revolving fund is a fund in which all income derives from organizational operations and revenue is available to finance continuing operations without fiscal year limitations. This type of account relies on sales, rather than direct appropriations, to finance operations and cover the full costs of operations.

Revolving fund concepts have been around since the early 1800s and in basic terms, the revolving fund activity accepts an order from a customer, finances the cost of operations using its "working capital" and then bills the customer who then reimburses the fund. [Ref. 33] The primary goal of a revolving fund is to manage the "total cost" of delivery DoD business functions with focused attention on recovering all costs on a break-even basis over time. Figure 3.1 demonstrates the WCF.

## How Does the Fund Operate?

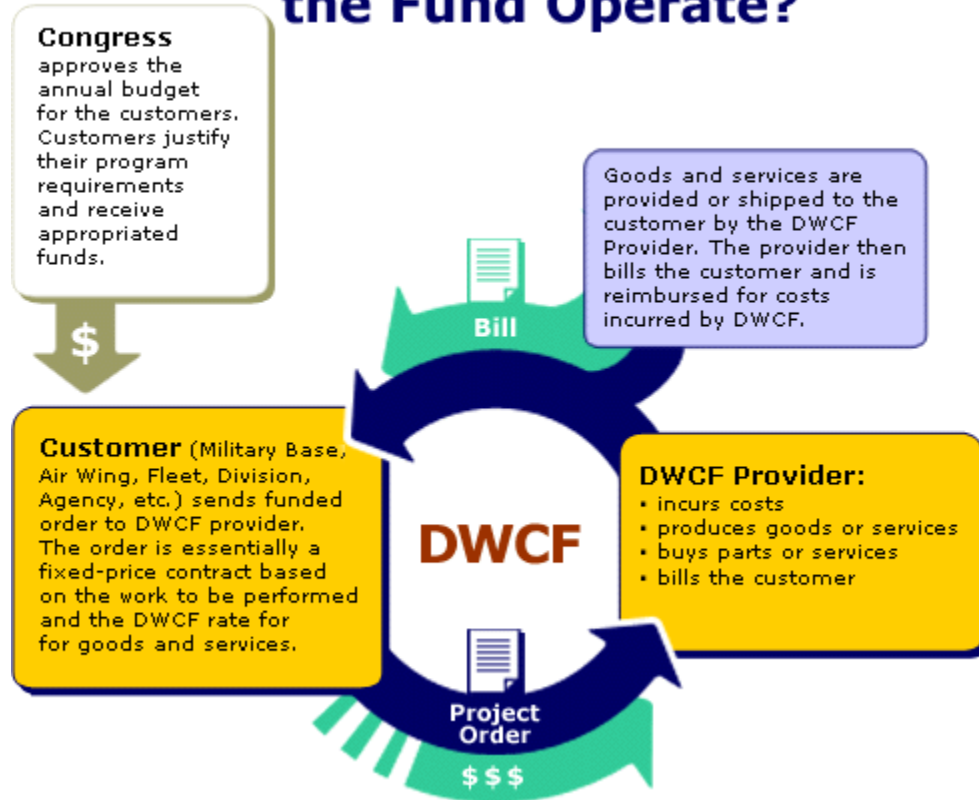


Figure 3.1. Revolving Fund.

Before 1992, the DoD divided the revolving funds into four stock funds and five industrial funds. In 1992, the DoD established a new fund combining all the DoD stock funds into one single revolving fund called Defense Business Operations Fund (DBOF). The philosophy of DBOF was to create and foster a more business-like environment in order to control costs in revolving fund activities. Specifically, DBOF concepts were to focus attention on the control of total costs of DoD business and centralize cash management. However, after 5 years of performing these duties, the OSD Comptroller with the guidance of the Defense Management Review Decision 910, returned the



management of the DBOF cash services to the DoD component levels to align cash management accountability with those entities responsible for the business activities funded. [Ref. 14]

In December of 1996, the Under Secretary of Defense eliminated the DBOF and established the four funds the DoD has currently: the Army Working Capital Fund, the Navy Working Capital Fund, the Air Force Working Capital Fund and the Defense-Wide Working Capital Fund. [Ref. 29] The DoD added a fifth fund, the Defense Commissary Agency, in 1999, and named the entire organization the Defense Working Capital Fund (DWCF).

#### **B. WORKING CAPITAL FUND FOUNDATIONAL STRATEGY**

The DWCF is a financial strategy that engages the use of competition in the free market and establishes clear customer/provider relations. The WCF adopts private sector techniques for resource management, consolidates various functions, and uses activity based accounting principles to display full costs. This gives management improved cost and performance data to make effective and efficient decisions and compete with other vendors for DoD assets. The DWCF builds upon the principles embodied in the free-market system to facilitate better business practices and budget decisions. Advantages of using the DWCF include:

- Identifies the total or "true" cost of DoD goods and services to Congress, military users (buyers), and those who provide goods and services (sellers), and thereby promotes more efficient and effective allocation and utilization of resources
- Underlines the cost consequences of certain choices and allows purchases to be made in anticipation of future funded orders

- Provides managers with the financial authority and flexibility to procure and use labor, materials, and other resources more effectively
- Improves cost estimates and cost control through comparison of estimates and actual costs
- Places customers in the position of critically evaluating purchase prices and the quality of goods and services ordered
- Allows for greater flexibility and security in decision-making, as there are no fiscal year limitations
- Establishes standard prices or stabilized rates and unit prices for goods and services furnished by DWCF business areas, enabling customers to plan and budget more confidently [Ref. 42]

The DWCF conserves resources by exposing costs that were previously not reflected in goods and services provided. Now that the provider has increased the cost visibility of their products, the customer can compare options on a fully informed basis and decide if they want to use the WCF provider. This exemplifies the foundation of the private market, a system that allows the consumer to choose the provider they desire at the price they can afford. If the price is too high or if the quality of work is not sufficient, the customer can search out another supplier. It is the foundation of supply and demand and a reflection of the competitive commercial market at work. The DWCF looks to add value through the integration of better business practices. Here are a few examples:

- Provides for total cost visibility and improved cost awareness
- Enables full cost recovery (capital costs can't be exceeded and money is saved for additional programming)

- Stabilizes rates to protect customers from inflation during execution
- Gives managers more flexibility because they know the true cost of their decisions
- Shifts the focus from spending to cost and cash management
- Minimizes costs because customers determine what they need and can justify their decisions and funding allocation
- Measures performance and promotes greater taxpayer accountability
- Allows for greater flexibility and security in decision-making, as there are no fiscal year limitations

### **C. REQUIREMENTS OF THE DWCF**

The establishment of the DWCF caused some financial changes but no operational changes. The idea behind the DWCF was to link cost and performance through total cost visibility and full cost recovery using the revolving fund concept. According to OSD, "The basic tenet for the DWCF financial structure is to create a customer-provider relationship between military operating forces and support organizations." [Ref. 7] Appendix B also gives some basic working definitions concerning DoD WCF terms.

There are three required elements for an organization to qualify as a Working Capital Operation. First, they must have an identifiable product or service; second, they must have customers that will buy the product or service; third, they must have a cost accounting system to provide total cost visibility. [Ref. 33]

The DoD organizes the WCF into Supply Management (Stock Fund) areas and non-Supply Management (Industrial) areas. The major difference between the two is the Supply

management operations receive contract authority that permits obligations in advance of customer orders, while the non-supply areas must have immediate budgetary resources in the form of customer orders. The actual outlay for the non-Supply Management may not occur until a future date, but the actual resources still must be available. [Ref. 33] The DoD places the Working Capital Funds into descriptive categories called Activity Groups. These are: Supply Management, Depot Maintenance, Research and Development, Transportation, Information Services, Public Works, Financial Operations, Distribution Depots, Defense Commissary Agency and Other (Printing etc.). Some of the Activity Groups are unique to each service, while others may cross all services and into Defense wide categories. All DoD components have Supply Management and Depot Maintenance Activity Groups. [Ref. 33]

#### **D. WORKING CAPITAL FUND BUSINESS MODEL**

A WCF organization receives the initial "working capital" through an appropriation order and transfer of resources from existing appropriations. This would be the equivalent to a corporation going public and issuing stock to the general market as an initial source of revenue. This working capital is the "corpus" and finances the initial cost of goods and services. After this initial lump sum transfer, the WCF does not receive annual appropriations for its operations but finances its activities through the receipt and acceptance of customer orders. Like the private sector, the organization must maintain enough revenue to cover all expenses or cease to exist. The replenishment of the fund occurs when the organization invoices the customer who then pays the bill.

The simple explanation of the revolving fund is like a personal checking account. The account holder deposits an initial amount of cash into the account and as they purchase goods and services, the transactions reduce the balance. To keep the checkbook in the black, you must make sure your expenditures do not exceed your income and as you take in new deposits, you bring the balance back up. Over time, the balance goes up and down, but should always stay in the black. By keeping the account balanced and tracking your expenditures and deposits, you make good solid judgments on purchases and ensure your account is in the positive.

The cash balance of the WCF, like the checkbook, maintains a positive balance and operates on a break-even basis over time, by recovering losses or returning gains through subsequent year rate changes.

#### **E. ACTIVITY BASED COSTING (ABC) IN THE WORKING CAPITAL FUND**

The DWCF, as a revolving fund system, recognizes that the selling price charged to customers by the fund should include all the costs involved in providing those goods and services. Working Capital Fund managers use Activity Based Costing to capture and allocate costs across a specific product.

The concept of unit costs is fundamental to Working Capital Fund Management. The revolving fund model defines the unit cost as the costs divided by the measurement of output. These measures of output are "cost drivers" and some examples are Direct Labor Hours or Unit of Goods Sold. In the ABC model, the providing activity influences the numerator, while the customer influences the denominator.

The WCF activity desires to maintain as low a cost as possible in order to maintain a low rate overall. This allows for a competitive price to the market place and the ability to maintain or even gain market share.

Cost elements are the drivers that produce cost output. For the WCF they can be the following:

- Direct Costs - Costs that are directly attributable to the end product or output. Direct costs are allocated over individual output units.
- Indirect Costs - Costs not directly tied to the operational output and normally allocated over a selected number of outputs. Indirect costs are those that are part of the end product, but are not economical to account for on an individual basis. Another reference of indirect costs is overhead costs.
- General and administration (G&A) - G&A costs are those that do not contribute directly to a specific product or output, but to overall operation and allocated across all outputs. These costs are overhead costs as well and remain relatively constant.
- Variable costs - Costs that are direct and indirect that vary with regard to workload. Labor and material costs would normally change with change in workload. These would be variable costs.
- Fixed costs - Costs that remain the same during operations. Variations in workload do not affect fixed costs.

By understanding the costs or cost drivers, managers can determine and understand the unit cost of an output. The manager can now make informed decisions regarding labor and material costs, resulting in better products and services at competitive rates.

For example, once a customer has estimated a requirement, the WCF organization initiates action. For description purpose, the organization uses Direct Labor Hours (DLH) as the primary cost driver. The program manager determines the number of Direct Labor Hours for the estimated work requirement and selects a price per hour from a fixed-price catalog. The accounting office creates the estimation of total costs called the Costs of Goods Sold (COGs), which includes G&A overhead costs and total labor cost. However, the organization must also adjust the rate for any prior year gains or losses. If the Command incurs a prior year loss, then the adjustment would result in an increase to the COGs. If the results were a gain, then the adjustment would result in a decrease to the COGs. The adjustment to the COGs is to strive for an Accumulated Operating Result (AOR) of zero or a breakeven point.

The final rate charged is the adjusted COGs divided by the total DLH product. The organization compares this rate to the prior year rate and applies it to the customer accounts.

#### **F. UNIQUENESS OF DOD IN THE FREE MARKET**

The use of the WCF process reflects the use of private-sector functional processes and allows the provider and customer a greater flexibility in making business decisions. The principles that are in use focus on reducing costs and establishing the foundation of promoting war fighting readiness and sustainability. Some of the functions in DWCF organizations do have some uniqueness because of the absence of the demand in the private market. Examples are Depot Maintenance and Research and Development where only the DoD uses certain shipboard or aircraft

capabilities and parts. Commercial contractors may have the ability to duplicate the process, but due to the uniqueness of war fighting capabilities, there is not the same competition to produce. This would result in a monopoly of that specific area for the Activity Group. However, the vast majority of DWCF areas produce similar products to the commercial sector, which creates open competition. Examples of this are Information Services, Printing, Transportation, and Financial Operations. The open market does provide these types of goods and services. Therefore, the DoD is in active competition with commercial providers to service the end user. The Public-private competition presents both an opportunity and a challenge to derive efficiencies through competition.

#### **G. CONCLUSION**

This chapter describes the background and history of the Defense Working Capital Fund and the foundation that it promotes effective allocation and utilization of resources. The Working Capital Fund fundamental premise stresses the cost consequences of certain business choices and allows purchases in anticipation of future funded orders. This provides managers with the financial authority and flexibility to procure and use labor, materials, and other resources more effectively, improves cost estimates and cost control through comparison of estimates and actual costs, and places customers in the position of critically evaluating purchase prices. Overall, the WCF improves the quality of goods and services ordered, allows for greater flexibility and security in decision-making, and establishes stabilized rates and unit prices for goods and services. The DWCF accomplishes this by using a total cost



model to increase the awareness of support organizations that are concerned with the costs of goods and services. DoD WCF Commands are recognizing the true cost of doing business and putting pressure on business area managers to reduce that cost. This is the free market at work. Lastly, the chapter evaluated the uniqueness of some DoD components and the relationship to the commercial market with regard to direct competition.

Given this foundation of the Defense Working Capital Fund, the next chapter will look at application of the A-76 study at the Working Capital Fund activity.

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#### **IV. A-76 STUDY AT A WORKING CAPITAL FUND ACTIVITY**

Chapter II introduces the A-76 process and provides a working understanding of how the study creates savings by introducing competition. Chapter III illustrates and examines the Defense Working Capital Fund and the internal cost efficiencies when competing in the commercial market. This chapter will discuss free market economics and Working Capital Funds and parallel the A-76 theory to this environment. This chapter will then address specific challenges when proceeding with the A-76 at a Working Capital Fund activity and evaluate NAVSISA, a Navy Working Capital Fund activity specializing in information systems, as it undergoes an A-76 study.

##### **A. BASIC FREE MARKET SYSTEM ECONOMICS AND WORKING CAPITAL FUNDS**

The market economy allows customers to make decisions on the goods and services they require and need. In market economics, everyone is free to pursue their own self-interest. Consumers economize to protect their scarce resources. Producers keep costs low and prices competitive to ensure that customers will buy their product, which will maintain demand flow in and profits up. Holding all variables constant, except the price of the goods (*ceteris paribus*), the outcome of the supply and demand relationship will result in an equilibrium price that balances the quantity supplied with the quantity demanded. If the customer discovers that the prices are too high for the product, they will look for a new product or a less expensive substitute product. As a result, the producer will continue to monitor the cost of their product to

maintain their market share. This forms the model of the Supply and Demand curves and illustrates the competitive process of the DWCF.

The advantages of using the WCF as a Free Market approach is:

- All support, not just a portion of support, resides within the revolving fund
- Revolving fund activities identify all the costs associated with the particular activity
- Support may be purchased from either internal or commercial sources
- A customer/provider relationship improves quality, reduces costs, and provides greater focus on customer needs

This illustrates how the presence of competition already exists in the Defense Working Capital Fund.

#### **B. A-76 AND DEFENSE WORKING CAPITAL FUND DIRECT COMPETITIVE PARALLELS**

Comparing the objectives of the A-76 process to the Working Capital Fund reveals several similarities. They are:

- Step 1 in the A-76, Packaging and Commercial Activity Identification, is equivalent to the WCF establishing a product or service that a customer needs and prepares a product to enter the market. In the Working Capital Fund, there is a continual packaging and identification process occurring based on the need of the customer.
- In step 3, the PWS and QASP is equivalent to the development of the cost drivers in the ABC model and full cost model. The WCF is continually evaluating its cost drivers and outputs to cut costs and determine what is driving costs. There is a constant evaluation of work statements and workforce to determine if the organization is utilizing human capital effectively. The Working Capital Fund is continually evaluating all of the

internal cost creating elements to generate a more competitive product.

- Steps 8 and 9 of the A-76 develop a comparison of costs. The WCF does the same thing by improving cost estimates and cost controls through the comparison of estimates and actual costs. This places customers in the position of critically evaluating purchase prices and the quality of goods and services. The customer also establishes a second cost comparison when comparing multiple businesses for the best quality product at the best price. This is the process of pre-competing business to find the right requirement at the lowest price.

These direct comparisons show how competition is currently taking place in the Working Capital Fund activity and the A-76 objectives met by the competition. The free market system already does what the A-76 sets out to do.

#### **C. A-76 AND DEFENSE WORKING CAPITAL FUND FUNDAMENTAL THEORIES PARALLELED**

As seen and discussed in Chapter II, the A-76 process creates efficiency through the introduction of market competition. The efficiencies occur when the Government organization creates a PWS and MEO to compete with the private sector best value proposal. The introduction of competition, through this outside mechanism, pushes organizations to engage in better business practices by driving cost efficiencies not normally considered. [Ref. 27] The purpose of the A-76 is to create economy and enhance productivity by keeping inherently governmental functions "in-house" and relying on the commercial sector for products and services determined more economically advantageous.

However, the A-76 process never distinguishes when the study is addressing a Defense Working Capital Fund

organization which is already in a competitive marketplace. As discussed in Chapter III, the basis of the Working Capital Fund emphasizes the cost consequences of certain choices and allows purchases in anticipation of future funded orders. The WCF provides Commands with the financial authority and flexibility to procure and use labor, materials, and other resources more effectively. In addition, the WCF improves cost estimates and cost control through comparison of estimates and actual costs and places customers in the position of critically evaluating purchase prices. The WCF improves the quality of goods and services ordered, allows for greater flexibility and security in decision-making and establishes stabilized rates for products furnished by DWCF businesses. DoD Defense Working Capital Fund Commands are recognizing the true cost of doing business and putting pressure on business area managers to reduce costs.

From this direct comparison, the WCF currently meets the objectives of the A-76 study by responding to the presence of competition. The DWCF already responds to the free market practices of supply and demand by examining costs and products and using commercially based business practices to gain efficiencies. The A-76 process does not recognize organizations that are already competing in the marketplace. The OPNAV and OMB staff confirmed this point in numerous conversations. [Ref. 26] Therefore, the parallel of the two systems shows a significant disconnect when trying to maximize cost and efficiency savings by using the lengthy and labor intensive A-76 process. The A-76 at a Working Capital Fund Activity strives to initiate competition where competition already exists.

**D. CHALLENGES WHEN PROCEEDING WITH THE A-76 AT DWCF**

There is no question that the A-76 tool works, the issue is that it is not the appropriate tool for Working Capital Fund activities. Because the A-76 process is blind to the competition that is already present at the WCF, the study would continue as listed in the steps provided in Chapter II over an 18 to 36 month timeframe. The only benefit the A-76 would give the WCF organization is a second opinion on whether the organization is operating at its maximum efficiency. Although every organization should use as many tools necessary to gain efficiencies in the DoD, the A-76 is a lengthy process examining a single point of time, when the market based WCF must frequently change to keep a competitive advantage. As emphasized in Chapter III, the WCF already presents both an opportunity and a challenge to derive efficiencies through competition.

**E. THE CASE STUDY OF NAVSISA, INFORMATION SYSTEMS WCF**

The Navy Supply Information Systems Activity, located on the Naval Support Activity complex in Mechanicsburg, PA is a major field activity and Defense Working Capital Fund operation of the Naval Supply System Command. Their mission is the central design for software applications supporting logistics, finance, and maintenance needs for the Navy, DoD, and Foreign Allies. The core products are business & financial systems, management systems, technical support, and project management for customers. Currently the NAVSISA key customers are Naval Supply Systems Command, Defense Finance & Accounting Service, Trident Strategic Programs Office, and Foreign Military Sales Customers.



Figure 4.1. NAVSUP Command Organization.

The organization is composed of 15 military and 795 civilians in multiple information technology skills.

NAVSISA determines their Annual Stabilized Rate using Billable Hours that equates to Billable Work Years (BWY) for each project. The following applies:

### Total Cost to Operate

$$\text{Rate} = \frac{(\text{All Labor} + \text{Non-labor} - (\text{Profit} + \text{Loss}))}{\text{Billable Employees} \times \text{Billable Hours}}$$



**Time Distribution:**

Hours available	2088
- Avg Annual leave	-180
- Admin Leave	- 19
- Holiday leave	- 90
- Sick Leave	- 76
- Training, Misc	- 73
<hr/>	
= Billable Hours	1650

The importance of the Rate equation and Billable Work Years is to give total cost visibility to the stabilized rate charged to the customer. In the Rate equation, the numerator is the cost of all employees (All Labor) added to the overhead costs (Non-labor) and the gains or losses from the previous year. However, in the denominator, only the number of Billable Employees (revenue generating) multiplied by the Billable Hours (1650) determines the revenue. This means that the technology talent or revenue generating functions of the organization sold must carry the cost of all non-revenue generating functions. Due to this driving factor, the organization is continually striving to minimize labor costs, maximize billable hours sold, while reducing overhead. This continual squeezing and pressure in the organization keeps their market rate low and maintains competition.

The example of NAVSISA demonstrates an organization that uses the WCF process in a highly changing information technology market. NAVSISA competes directly in the information technology market just like any other IT provider in the private sector. In fact, the NAVSISA major customer NAVSUP recently gave a large piece of technology business, an Enterprise Resource Planning (ERP) implementation, to another provider. This competition proves how active the free market is in this type of Working Capital Fund operation and how some DoD organizations are free to use whatever source they desire to meet their needs. Therefore, the WCF must continue to monitor their internal costs and provide the best business practices in order to win work each year and stay solvent.

**F. APPLYING THE A-76 AT NAVSISA**

Presently, NAVSISA is undergoing an A-76 study that specifically targets the reduction of all non-inherently governmental FTE in the organization. The A-76 is evaluating 466 revenue generating software engineers and administrative support positions using a FY99 commercial activities inventory as the FTE baseline. The estimated time of the study will take 30 months to complete. NAVSISA estimates 10 billable work years to complete the study at a total cost of \$2.2M. The current study is proceeding with a combination contract and in-house team. The A-76 will focus on two aspects of NAVSISA, the achievement of economy and enhanced productivity through competition and the shift to less expensive commercially available sources to provide commercial products and services. In accordance with the provisions of the OMB Circular, the Government shall not conduct any activity to provide a commercial product or

service if the product or service is available more economically from a commercial source. [Ref. 27] If the A-76 can show that NAVSISA can conduct business using a contract force instead of the current FTE, then the decision is to move to a private sector provider. This would create a lower stabilized rate on all contract work at NAVSISA.

Again, the A-76 is evaluating NAVSISA based on cost comparison only. The study does not take into consideration the quality of work or timeliness of work completion. The A-76 is a cost comparison tool only.

#### **G. CONCLUSION**

This chapter focuses on how the Working Capital Fund applies free market economics and how the foundational objectives of the Defense Working Capital Fund and the A-76 study parallel each other. The chapter demonstrates how competition is already taking place in the Working Capital Fund and how it already meets the goals of the A-76 study, making the A-76 an expensive verification tool.

Finally, the chapter shows specific challenges when doing an A-76 at a Working Capital Fund activity such as the inability of the study to recognize the existence of competition. The research also illustrates how the A-76 is a lengthy process examining only a single point of time at the free market based Working Capital Fund organization that must frequently adjust and change to keep a competitive advantage. A case study presents NAVSISA as a Navy Working Capital Fund activity currently undergoing an A-76 study.

The next chapter will present conclusions, recommendations, and suggested areas for further research.

## **V. CONCLUSIONS AND RECOMMENDATIONS**

### **A. INTRODUCTION**

The objective of this thesis is to address the appropriateness of applying an OMB Circular A-76 study process on the revenue generating functions in Defense Working Capital activities. Furthermore, the focus is to determine if the A-76 study is indeed suitable for the specific purpose of gaining cost efficiencies in the Working Capital Fund. While the research acknowledges that A-76 studies have gained efficiency with competition, the goal of the thesis is to show that some Working Capital Fund activities currently maintain a constant state of competition, therefore a process other than the A-76 would be more appropriate to gain further efficiency. The thesis evaluates the Navy Supply Information Systems Activity (NAVSISA), as a case study of a Navy Working Capital Fund organization undergoing an A-76 study.

### **B. CONCLUSIONS**

- **Is the OMB Circular A-76 process appropriate for cost reduction and the gaining of efficiency in a Working Capital Fund organization?**

The analysis of the A-76 process shows the successful results of cost savings using the study process, however there is no recognition in the OMB Circular A-76 process for an activity that is already in a state of competition and gaining efficiencies. As stated in Chapter II, the objective of the A-76 is to introduce competition through an outside mechanism by pressing organizations to engage in better business practices by driving cost efficiencies not typically considered. The A-76 does not specifically

address Working Capital Fund organizations that operate in the competitive free market. As shown in Chapter IV, the A-76 and WCF ideologies parallel and therefore the A-76 is duplicating the process of competition already taking place at the WCF.

Recognizing that competition currently exists at some Working Capital Funds, the A-76 would simply be a verification tool to ensure maximum efficiencies. This is where the A-76 becomes an inappropriate tool, as it is an extremely arduous process at the scheduled 18 to 30 month minimum and considerably expensive compared to other cost efficiency validation tools. Furthermore, the WCF workloads change overtime, yet the A-76 process gives a Performance Work Statement for a specific period only. The Working Capital Fund activity must adjust to workload requirements that expand and contract with the demand of the free market. The revenue generating functions at a WCF activity in 30 months may not look anything like it did when the original A-76 study began. The A-76 MEO would only be a best guess for future years and not the correct measurement device for a competitively changing organization. The best guess MEO could end up being a very risky guess if it is significantly different then the out year requirements.

The A-76 as a verification tool can also become extremely expensive. NAVSISA estimates 10 billable work years to complete their study with a combination contract and in-house team. The estimated total cost for the study is \$2.2M, which is a very expensive verification tool. Therefore, the more appropriate tool would be a value chain

consulting operation at half the cost that gives a better evaluation over a shorter period.

The only way to save DoD dollars at the DWCF is to produce the same output cheaper, which means lower rates for the WCF customer. The A-76 could verify that this processes is occurring, but is an expensive and drawn out cost efficiency tool to use.

- **What is the basis and objectives of the A-76 study?**

Chapter II of the thesis gives a full description of the history, background and objectives of the A-76 process dating back to the origin in the 1955 Eisenhower Administration. The A-76 has gone through several changes ultimately emerging as a complex efficiency tool used regularly by the DoD as a cost reduction mechanism. The A-76 has been an effective tool used to create savings by introducing competition and striving for the goals of economy and enhanced productivity in DoD organizations. However, Chapter II shows that the A-76 does not recognize those commands that are already in a state of competition, such as the Working Capital Funds. One of the critical flaws of the A-76 process is that it does not distinguish the type of organization it evaluates.

- **How does a Working Capital Fund operate competitively and financially?**

Chapter III gives a full description of the Defense Working Capital Fund and the business strategy and model. The DWCF uses a revolving fund concept that engages the use of competition in the free market and establishes clear customer/provider relations, adopts private sector techniques for resource management, consolidates various

functions and uses activity based accounting principles to display full costs. The research shows how the Working Capital Fund theory stresses the cost consequences of certain choices and allows informed purchases made in anticipation of future funded orders. The WCF provides Commands with the financial authority and flexibility to procure and use labor, materials, and other resources more effectively, improves cost estimates and cost control through comparison of estimates and actual costs, and places customers in the position of critically evaluating purchase prices. Overall, the WCF improves the quality of goods and services ordered, allows for greater flexibility and security in decision-making, and establishes stabilized rates and unit prices for goods and services furnished by DWCF business areas. DoD WCF organizations are recognizing the true cost of doing business and putting pressure on business area managers to reduce those costs.

- **What other means of cost-cutting are in place at Defense Working Capital Funds?**

Chapter IV describes how the Defense Working Capital Fund is part of the market economy that creates an internal drive to maintain total cost visibility and cost reductions to establish a constant or growing customer base. If the customer discovers that the prices are too high for the product, they will look for a new product or a less expensive, substitute product. This keeps the producer continually monitoring the cost of the product to maintain the market share. The presence of competition and free market economics contribute to a cost-cutting environment in the Working Capital Fund.



- **Have A-76 studies shown effectiveness at Defense Working Capital Fund activities?**

Chapter III illustrates how the A-76 has been successful in DoD with an estimated 30% savings through a reduction in FTE, but after continued discussions with OMB and OPNAV, they do not divide the results of the A-76 studies by the type of Command. OMB and OPNAV could not supply any data that supported that the A-76 had been effective at WCF organizations, only that the average was 30%. Therefore, further research is required to determine if the savings at WCF vary significantly from those at mission-funded activities.

- **Are there parallels between the current DWCF business strategy and the objectives of the A-76 study?**

Chapter IV of the thesis draws the direct parallels between the competition that already exists in the WCF and the objectives of the A-76 study. The research shows that the WCF already meets many of the objectives of the A-76 study by the presence of competition. The DWCF currently responds to the free market practices of supply and demand by creating total cost visibilities and product definition and using commercially based business practices to gain efficiencies. The research also shows that the A-76 study does not recognize these parallels.

- **What challenges are there when doing an A-76 at a Working Capital Fund Activity?**

Chapter IV specifically addresses the challenges that arise when doing the A-76. Specifically, the A-76 study changes into a cost verification tool because the WCF is already in a state of competition. As a result, the A-76 is a very expensive and lengthy process used to verify that

a competitive organization in the free market constantly achieves cost efficiency. The duration of the A-76 process and the cost of the study, bring about the inappropriateness and the need for a different tool for the OMB when evaluating Working Capital Funds.

### **C. RECOMMENDATIONS**

The research presented in the thesis shows that the A-76 does work, but it is an inappropriate efficiency tool at the Defense Working Capital Fund Activities. The OMB should therefore do the following:

- Modify the current A-76 Circular to identify when a Command is a Working Capital Fund organization. Once the A-76 process identifies that the organization is a WCF, the A-76 will switch to a new OMB A-76/WCF cost evaluation tool.
- The new OMB A-76/WCF evaluation will follow the principles of process reengineering that critically examines, rethinks, and redesigns mission-delivery processes. The new A-76/WCF tool would use the foundation of a functional assessment - which is the identification of significant changes in existing DoD business units in order to achieve the goal of appreciably reducing infrastructure costs - and add a modified A-76 cost comparison. The strength of the A-76 is the ability to do a cost comparison with outside businesses to move into an outsourcing model if deemed cost effective. This is the teeth of the A-76 and the necessary addition to the functional assessment. The new OMB product will be a "Functional Assessment with teeth." This product will evaluate previous work done in the last 6 months by the WCF and run a simplified cost comparison using outside vendors for cost evaluations. If the cost of the work at the WCF is 10% higher than the competitive market, the organization proceeds with a full study. If the snapshot evaluation is less than 10%, the organization proceeds with a Functional

Assessment with the addition of the modified cost comparison.

- The organization conducts the entire "Functional Assessment with teeth" in a maximum period of 9 months. This allows a current evaluation of the organization in an appropriate amount of time.

#### **D. SUGGESTED AREAS FOR FURTHER RESEARCH**

During this study, the researcher found the following areas that warrant further research:

- The research shows how Working Capital Funds reduce costs and gain efficiencies by competing in the market economy. However, the Civil Service rules are often difficult to work with when an organization wants to decrease the labor force. Further research is necessary on whether current Civil Servant employment rules allow WCF organizations to operate competitively in the free market.
- The research showed significant savings by the A-76 processes (30%) listed as FTE reduction savings. Further research is necessary on what savings, if any, resulted in the non-labor categories from the transformation of organizations.
- The thesis provides recommendations for alternatives to the OMB A-76 process. Further research is necessary to expand on other alternatives to replace the A-76 process at WCF organizations.
- Further research is necessary to verify what portions of Defense Working Capital Funds are truly pre-competed and verify what portions of WCF have market competition.
- The DWCF is currently pricing products based on cost of the operations, not on what the market will bear. Further research is necessary on defining costs, cost allocation systems, and pricing strategies to compete better while covering the cost of operations.
- From the baseline commercial activity inventory until the end of the A-76 study based on that

inventory, three to four years could pass. Research should be conducted that would evaluate how much savings occurred through routine management decisions during this time that are credited to the A-76 process but did not actually derive from it.

## **APPENDIX A. OMB DESIGNATED INHERENTLY GOVERNMENTAL FUNCTIONS**

The following is an illustrative list of functions considered inherently governmental functions:

1. The direct conduct of criminal investigations.
2. The control of prosecutions and performance of adjudicatory functions (other than those relating to arbitration or other methods of alternative dispute resolution).
3. The command of military forces, especially the leadership of military personnel who are members of the combat, combat support or combat service support role.
4. The conduct of foreign relations and the determination of foreign policy.
5. The determination of agency policy, such as determining the content and application of regulations, among other things.
6. The determination of Federal program priorities or budget requests.
7. The direction and control of Federal employees.
8. The direction and control of intelligence and counter-intelligence operations.
9. The selection or non-selection of individuals for Federal Government employment.
10. The approval of position descriptions and performance standards for Federal employees.
11. The determination of what Government property is to be disposed of and on what terms (although an agency may give contractors authority to dispose of property at prices within specified ranges and subject to other

reasonable conditions deemed appropriate by the agency).

12. In Federal procurement activities with respect to prime contracts,
  - (a) determining what supplies or services are to be acquired by the Government (although an agency may give contractors authority to acquire supplies at prices within specified ranges and subject to other reasonable conditions deemed appropriate by the agency);
  - (b) participating as a voting member on any source selection boards;
  - (c) approval of any contractual documents, to include documents defining requirements, incentive plans, and evaluation criteria;
  - (d) awarding contracts;
  - (e) administering contracts (including ordering changes in contract performance or contract quantities, taking action based on evaluations of contractor performance, and accepting or rejecting contractor products or services);
  - (f) terminating contracts; and
  - (g) determining whether contract costs are reasonable, allocable, and allowable.
13. The approval of agency responses to Freedom of Information Act requests (other than routine responses that, because of statute, regulation, or agency policy, do not require the exercise of judgment in determining whether documents are to be released or withheld), and the approval of agency responses to the administrative appeals of denials of Freedom of Information Act requests.
14. The conduct of administrative hearings to determine the eligibility of any person for a security clearance, or involving actions that affect matters of

personal reputation or eligibility to participate in Government programs.

15. The approval of Federal licensing actions and inspections.
16. The determination of budget policy, guidance, and strategy.
17. The collection, control, and disbursement of fees, royalties, duties, fines, taxes and other public funds, unless authorized by statute, such as title [31 U.S.C. 952](#) (relating to private collection contractors) and title [31 U.S.C. 3718](#) (relating to private attorney collection services), but not including:
  - (a) collection of fees, fines, penalties, costs or other charges from visitors to or patrons of mess halls, post or base exchange concessions, national parks, and similar entities or activities, or from other persons, where the amount to be collected is easily calculated or predetermined and the funds collected can be easily controlled using standard cash management techniques, and
  - (b) routine voucher and invoice examination.
18. The control of the treasury accounts.
19. The administration of public trusts.

With respect to the actual drafting of congressional testimony, of responses to congressional correspondence, and of agency responses to audit reports from an Inspector General, the General Accounting Office, or other Federal audit entity, please see special provisions in [subsection 6.c](#) of the text of the policy letter, above.

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## **APPENDIX B. WORKING CAPITAL FUND DEFINITIONS**

**Accumulated Operating Results (AOR).** Under a revolving fund full cost recovery concept, stabilized prices and rates are set at the beginning of the fiscal year for each business area to break even. During budget execution, each business area will experience a positive or negative Net Operating Result (NOR). The consolidation of all business area NORs is the Accumulated Operating Result (AOR). Each Component strives for a break even AOR for each activity within a business area under its management control.

**Annual Operating Budget (AOB).** The AOB is a funding document that provides the basis for earning budgetary authority. The AOB identifies every unit cost output and its associated unit cost goal. The AOB is released from the Under Secretary of Defense (Comptroller) to the DoD Components. The Components may further disseminate authority by releasing AOBs with approved unit cost goals to their subordinate activities.

**Capital Assets.** Depreciable property, plant, equipment, and software developed, manufactured, transferred or acquired at a specific point in time for a determined cost of \$100,000 or more; are used over some period (useful life), the length of which is to be two years or greater; and generally, become economically worthless (except for residual value) at the end of their estimated useful lives.

**Capital Budget.** Contains authorization to acquire capital assets that include depreciable property, plant, equipment, and software developed, manufactured, transferred or acquired during a fiscal year for a determinable cost of \$100,000 or more, and having a useful life of two or more years.

**Cost of Goods Sold (COG).** COG represents the average acquisition cost of the items sold. Although the exact calculations can be accomplished in several ways, they are obtained for each National Stock Number (NSN) by spreading the amount of the investment made to acquire (purchase or credit) the inventory over the number of items in the inventory, times the number of items sold. This matches the sales revenue in one period with the transactions affecting costs, which may have occurred in several

previous periods. COGs are not affected by surcharge rates, obligations for replenishment, or net outlays. COGs are the essential baseline for obtaining operating results and establishing prices.

**Net Operating Result (NOR).** Under a revolving fund full cost recovery concept, stabilized prices and rates are set at the beginning of the fiscal year for each business area to break even. During budget execution, each business area will experience a positive or negative Net Operating Result (NOR). The consolidation of all business area NORs is the Accumulated Operating Result (AOR). Each Component strives for a break even AOR for the business areas under its management control.

**Operating Budget.** The operating budget contains the annual operating costs of an activity or component, including depreciation or amortization expenses, and major maintenance and repair.

**Unit Cost (UC).** The term Unit Cost is synonymous with the term Cost per Output. The relationship of resources consumed to outputs produced. Simply stated, Unit Cost is the Cost of Resources divided by the Number of Outputs.

**Unit Cost Goal (UCG).** The maximum allowable cost to be incurred in the production of an output. To derive the goal, all projected costs (i.e., direct, indirect, and G&A) associated with an output are divided by the expected workload. The Under Secretary of Defense (Comptroller) develops and issues unit cost goals at the Component level for each support area. [Ref. 9]

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